Internal Revenue Service
memorandum

date: NOV 21 199

to: Curt Rubin, District Counsel, Manhattan

from: Barbara Felker, Senior Technical Reviewer, CC:INTL:Br5

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subject: [redacted]--Factoring Income

This memorandum summarizes our conversations of October 28 and November 6, 1991, concerning whether income characterized by the taxpayer as related party factoring income for calendar years [redacted] and [redacted] should be treated as interest income subject to withholding. I understand that [redacted] entered into a "factoring agreement" with its wholly-owned Bermuda CFC in [redacted] and a similar arrangement with its Barbados captive insurance company in [redacted]. It is not clear how funds were transferred from the CFCs to the taxpayer to pay for the receivables. The writeup indicates there was an initial cash transfer in [redacted], after which time the taxpayer routinely identified factored accounts at the end of each month and wired funds representing the net amount due (collections minus new purchases) to the CFCs. The Bermuda CFC made an additional $[redacted] cash purchase in [redacted].

The Bermuda CFC had no employees and accordingly did not select the receivables to be transferred. [redacted] performed all collection activities, commingled the proceeds from factored and nonfactored receivables in its own accounts, and included all the receivables on its books and financial statements. The taxpayer deducted factoring charges of $[redacted] in [redacted] and $[redacted] in [redacted] based on a [redacted]% discount factor.

As we discussed, related person factoring discount is treated as interest after March 1, 1984, for purposes of subpart F under section 864(d), and factored receivables are investments in U.S. property that may also give rise to an income inclusion at the shareholder level under section 956. However, these provisions do not support an adjustment in [redacted]'s case because the CFCs had E&P deficits in [redacted] and [redacted], at which time a worthless stock loss was claimed. The international examiner proposes to assert a [redacted]% withholding tax liability with respect to the wire transfers, on the theory that consistent with section 482 principles the discount should have included a stated interest charge.

The agent's writeup suggests that the arm's-length commercial practice is "maturity factoring," in which the factor

does not pay the seller for the receivables before they are collected. If funds are advanced prior to collection, the agent suggests that an interest charge will be separately stated, and that the discount should reflect only the factor's charges for performing collection activities and assuming the risk of noncollection. The agent also suggests that where the seller does not inform its customers of the assignment, but continues to perform the collection function, this fact indicates that the transfer constitutes a pledge of receivables as collateral for a loan, rather than a sale.

As we discussed, additional factual development would be useful to clarify the theory you should pursue. If the arrangement between [redacted] and its CFCs constituted a bona fide factoring arrangement, i.e., if receivables were sold to the CFCs, then the discount is not interest as a matter of law, even though an element of the discount reflects compensation for the use of the funds advanced. See Elk Discount Corp. v. Commissioner, 4 T.C. 196 (1944). While maturity factoring is a form of commercial factoring, it is not uncommon for unrelated factors to advance funds to purchase receivables in advance of the average due date of the receivables and to increase the discount accordingly. See generally the enclosed article on International Factoring. An interest charge need not be separately stated. In any case, the Service generally does not impute interest on intercompany trade receivables incurred in the ordinary course of business until the first day of the third month following the month in which the debt arises. § 1.482-2 (a)(iii)(B). Accordingly, if the substance of the arrangement between [redacted] and its CFCs is that of seller and purchaser of receivables, in my view it would be difficult as a legal matter for us to recharacterize all or a portion of the discount as interest.

On the other hand, if the substance of the transactions is that the CFCs lent funds secured by the receivables, so that ownership of the receivables remained with [redacted], the "discount" may constitute interest on the intercompany loan. Relevant facts bearing on the question of whether a transfer of receivables constitutes a sale or a loan are discussed in PLR 8809028 (March 1988). The fact that [redacted] continued to commingle the accounts and reflect ownership of all receivables on its books and records, and that the CFCs performed no services in connection with the "factored" receivables, support the characterization of the transaction as a rollover loan, although the legal transfer of the risk of loss is generally given great weight in this factual determination. Finally, I recommend omitting the agent's discussion of G.C.M. 39220 (May 31, 1983), which characterized factoring discount as income from the performance of services, since that G.C.M. was revoked by G.C.M. 39652 (July 22, 1987).

You may also wish to consider the collateral consequences of

characterizing the factoring arrangement as a loan, e.g., whether [redacted] may have realized discharge of indebtedness income by reason of its failure to repay the original advances. If you need further assistance in developing the case, please contact Phyllis Marcus on FTS 566-6645.